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ENHANCING THE COMPETITIVENESS OF SMEs THROUGH LINKAGES

Background paper prepared by the UNCTAD Secretariat*

Executive summary

The ability of SMEs to compete in the global market place depends on their access to certain critical resources the most important of which are finance, technology and managerial skills. TNCs have been an important means for SMEs to gain access to new technologies and management know-how. The shift in corporate production strategies from simple integration to more complex integration has widened the opportunities for SMEs while at the same time raised the requirements for entering TNC networks. The current challenge for developing countries is first to adopt policies to deepen the developmental effects of FDI by attracting TNCs willing to forge such linkages and then to undertake measures to promote such linkages between TNCs and SMEs. This paper reviews various types of linkages and spillovers along with their opportunities and risks, considers the underlying determinants of such linkages, and summarizes lessons learned from the recent workshop on building such linkages. It is commonly believed that the type and strength of linkages established depends to a large extent on the technological and other resource capabilities of local firms. Special support measures and programmes are necessary to nurture these capabilities. Such interventions have little chance of success if they do not respect the principle of subsidiarity (allowing each entity to undertake what it can do best) and are not embedded in a coherent policy framework to foster investment, competition, technology transfer, and SME development. Recommendations are made for measures to improve local SME performance, and upgrade the SMEs with in the context of TNC linkages.

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INTRODUCTION

1. International production – production under the common governance of transnational corporations (TNCs) is growing faster than other economic aggregates. Both the output and sales by the foreign affiliates of TNCs grew faster than world GDP and exports. This has been fueled by the phenomenal growth in foreign-direct-investment (FDI) flows from $209 billion (1990) to $865 billion (1999).[1]

2. The volume of FDI flows to developing countries has also grown dramatically. Their share of global FDI inflows rose from 18 percent in 1990 to a high of 38 percent in 1997 and fell to 24percent in 1999.[2] While FDI inflows are unevenly distributed among developing countries, the importance of this source of capital, measured in terms of the ratio of FDI to GDP, is increasing in most developing countries. Moreover, FDI has proven to be the most stable source of capital, proving relatively more resilient during the recent Asian and Brazilian financial crises, than other private capital flows, such as debt and portfolio equity flows.[3]

3. FDI not only involves flows of capital but also transfers technology and know-how, which are important for development. TNCs, through their investment activities, can disseminate technologies, technical capabilities and skills, and organizational and managerial practices to their business partners and other firms in host countries, enhancing the competitiveness of these firms.[4] With the increasing knowledge intensity of production and its implications for competitiveness, product quality, production processes, managerial skills and the capacity for technological innovations of TNCs are improving constantly. As a result, total factor productivity of TNCs tends to be higher than that of local firms in developing countries. This productivity gap has important implications for developing countries. On the one hand, TNCs can serve as important channels for the transfer of technologies, marketing and managerial skills to SMEs. On the other hand, there is always the possibility that TNCs crowed out local firms.

4. In the current globalization process, new rules of competition are leading to a reorientation of corporate production strategies. Many TNCs are switching from simple one-way organizational patterns of production with their affiliates to more complex forms of global networking with them. Meanwhile, TNCs are specializing in certain core capabilities, at the same time outsourcing the provision of non-core products, processes and services.

5. Although this reorganization has opened up new opportunities for linkages between TNCs and SMEs through local sourcing, the vast majority of SMEs remain de-linked from TNCs, missing these potential opportunities. Normally local sourcing is preferred because proximity lowers costs, allows for closer monitoring, and gives greater flexibility in changing specifications and in developing new inputs[5]. In reality, however, TNCs urge their home country suppliers to become global players, raising the barriers to entry for local SMEs in the host countries. TNCs assert that there is no lack of opportunities for them to forge linkages but rather a lack of suitable local SME partners, which would meet TNC's corporate standards or international standards of production. For local SMEs, "partnership readiness", a pre-requisite for mutually beneficial linkages with TNCs, often remains an elusive objective because SMEs lack information, experience, contacts and above all, the human and financial resources to implement urgently required changes in the managerial systems and technological base of their enterprises. The challenge for developing

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1 UNCTAD (1999, 1994).
2 UNCTAD (1999:20).
3 UNCTAD (1998: 14-15).
4 UNCTAD (1995: 148-190).
5 UNCTAD (1999).

countries is to ensure that such linkages occur and they contribute to the growth and competitiveness of SMEs and the development of the economy as a whole. Toward this end, a set of specific policies and measures are required.

6. Most of the policies which governments could adopt to forge linkages lie within the realm of creating an enabling business environment for both the TNCs and SMEs. The general policies and support measures for "growing" SMEs have been the subject of the previous four expert meetings and their conclusions and recommendations are contained in *Development Strategies and Support Services for SMEs*. In addition a special round table on TNC-SME Linkages for Development: Issues, Experiences, and Best Practices was convened during UNCTAD X in Bangkok, Thailand. It explored how the development actors, including those from the corporate sector, can contribute to building linkages between TNCs and SMEs. Panelists included policy-makers, CEOs and business association representatives.

7. The main focus of the Round table discussion was on various ways and means to deepen the quality of FDI and the development impact of TNCs. Government representatives outlined special policies, which they had adopted to promote linkages. For example, job creation was at the forefront of the Ireland's economic policy and the main focus of business development agencies such as Enterprise Ireland Agency. The Indian Government in reacting to the winds of global change focussed its policy initiatives on assisting industry and SMEs to benchmark themselves against global standards. Five decades of sustained policy support and a number of promotional and institutional agencies helped Indian SMEs to come of age. In Thailand basic policies ensured that the state provided industry with physical infrastructure, technological resources and manpower development. Local content requirements were an important factor in giving local firms access to TNC technology. Other Asian governments and States (Republic of Korea, Malaysia, Province of Taiwan, China) have included various incentives in the form of tax breaks, preference in public contracts, and soft credit lines for both TNCs and SMEs to intensify relations and technology transfer.

8. It is not the intention of this paper to dwell on policy issues and responses but rather to cover new ground by examining the practical support measures or best practices to promote linkages that can be undertaken by governments, meso-institutions and firms particularly within the context of public-private sector partnerships. This approach is mandated by the Bangkok Plan of Action, para. 119 which requires UNCTAD to analyze links between SMEs and TNCs.

Chapter I: VARIOUS TYPES OF LINKAGES AND SPILLOVERS: OPPORTUNITIES AND RISKS

9. Linkages and spillovers between TNCs and SMEs may be categorized into four main types:

- *Backward linkages with suppliers*: TNCs source parts, components, materials and services from suppliers in the host economy. The effect of such linkages on local SMEs depends on the quantity and types of supplied inputs, the terms of procurement, and the willingness of TNCs to transfer knowledge and build a long-term relationship with SMEs. Supplier linkages range from arms-length market transactions to very close, long-term, inter-firm cooperation.

- *Linkages with technology partners*: Some TNCs initiate common projects with local SME partners. These projects may take various forms of equity or non-equity linkages, including joint ventures, licensing agreements and strategic alliances. Although inter-firm technological alliances are a typical

phenomenon of OECD countries, which host most of the world's innovative companies, the number of inter-firm technology agreements involving partners from developing countries is increasing.[6] Some host countries require foreign investors to take on local partners in joint ventures or to license technology to local firms. In other cases, linkages with technology partners arise voluntarily, because both parties identify complementarities and anticipate benefits from such partnership. While some consider these linkages to be a subset of backward linkages, they are fundamentally different in terms of the degree of independence of the local firm from its transnational partner.

- *Forward linkages with customers*: The first and most important forward linkages developed by TNCs are with marketing outlets. TNCs outsourcing the distribution of brand name products often make considerable investments in the performance of their marketing outlets, e.g. restaurant chains, automobile or petrol companies. The second is with industrial buyers. TNCs producing machinery, equipment or other inputs sometimes offer after-sales services beyond the usual advice on how to use and maintain the purchased good. The third type refers to linkages in which a TNC produces goods for secondary processing, mainly commodities.

- *Other spillover effects*: These include demonstration effects, human capital spillovers, and other effects particularly on competitors. Demonstration effects occur as TNCs introduce new, more efficient ways of doing things, providing showcases for innovation. Local entrepreneurs may imitate TNC products and management techniques or gain access to non-traditional markets. This may happen as a spontaneous or unconscious process or as a planned and systematic exercise. Human capital spillovers occur when TNCs train personnel beyond their own needs or when their experienced personnel move to local firms or form new spin-off companies. Effects on competitors occur when TNC affiliates face some competition from local firms. As TNCs typically hold a strong market position vis-à-vis local rival firms, they may have a strong, positive or negative, impact on the performance of the latter. TNCs may set new standards and create a healthy competition that stimulates innovations throughout the whole industry, but they may also out-compete established local firms.

10. The four types of linkages presented above may have very different impacts on the development of the host country and its local SMEs. Given the breadth of the topic of linkages, this paper examines in greater detail those cases in which SMEs are partnered with TNCs as suppliers since these may have the deepest impacts and are the hardest types of linkages to promote.

A. Backward linkages with suppliers

11. Economies of developing countries are often characterized by polarized enterprise structures where only large and small, but no middle-sized firms exist, along with technological heterogeneity, and segmented goods and labor markets between them. A stronger integration of their SMEs into modern supplier chains can make an important contribution towards improving the enterprise size structure. A well-balanced structure of enterprise sizes may emerge where the economies of scale in production are ideally combined with the flexibility of small enterprises. SMEs can profit from this situation in a number of ways. The large

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[6] According to the MERIT/ UNCTAD database, 6.2 % of the 3,984 agreements recorded in the 1990s involved firms from developing countries, compared to 4.9 % in the 1980s (UNCTAD 1998:27).

enterprises, being their customers, open up new markets for them, often facilitate regular sales and growth, which permits economies of scale. Such links may relieve them of marketing tasks and provide an important impetus for modernization.

12. Yet, not all supplier relations are equally beneficial to SME development. In most cooperative ventures, suppliers depend on the customers. Quite often there are a great number of suppliers and only few customers, resulting in a situation when existing suppliers can be replaced by others when they lack specific capabilities. In such a case, the bargaining position of suppliers is extremely weak, and the risk of suppliers' engaging in ruinous competition is high. The customer is then in a position to appropriate the major share of all benefits resulting from specialization, while the suppliers have to absorb costs and risks.

13. Depending on the advantages that a supplier offers to its client, four types of relations may be distinguished. Each of them implies different opportunities for SME development.

- *Productivity gains*: The main motive of a TNC for outsourcing products and services is that the supplier SME is able to produce better or cheaper products than itself. If the underlying rationale of the customer is to make use of technological specialization and/or economies of scale of the supplier, the latter has a relatively high autonomy over product design and will be responsible for improvements. Since the supplier produces a specialized complementary input for the customer, the latter cannot easily play one supplier off against another. This gives the SME a certain bargaining power. The most privileged suppliers are those which achieve technological leadership in their field and are thus able to negotiate high prices, or innovation rents, for their products. In addition, the specialized supplier gains access to a reliable market, provided the customer remains viable. Intra-industry linkages based on mutual specialization usually go beyond arms-length transactions, toward the coordination of delivery times, product standardization, joint research, and so on. Such agreements would guarantee a long-term commitment on the part of the customer.

- *Factor-cost advantages*: The suppliers tend to have access to cheaper basic factors, mostly lower labor costs, due to the informality of the workshop or a non-unionized workforce. If a TNC customer establishes a relationship with a supplier only to cut wage costs, the terms are usually far less beneficial for the supplier. The supplier can only survive if it achieves leadership on a cost basis. When the production process is standardized and the necessary technology is available to many competitors, price competition is usually fierce, forcing firms to continuously cut costs. Unless suppliers achieve extraordinary increases in productivity, they are obliged to reduce profits, wages and labor standards.

- *"Passive" (numerical) flexibility*: Occasional subcontracting for the purpose of increasing production in the case of demand peaks usually does not provide a sound basis for SME development. The supplier has to accept short-term contracts and cushion fluctuations in demand through varying working hours. As a result, there is little stability and security for the supplier, which can easily lose its investments if the customer does not receive orders in excess of its own capacity. Moreover, the customer often transfers the cost of inventory to the supplier. Due to the instability of such relationship, neither the customer nor the supplier's management will show a long-term commitment to invest in machinery or workforce skills.

- *"Active" (functional) flexibility*: In some cases suppliers are able to respond to fluctuations in demand by way of functional, rather than numerical, flexibility. This means that they can rapidly switch production processes and flexibly modify the quantity of output. Preconditions for such a flexible

system of production are multi-skilled workers, programmable multi-purpose machines and a flexible shop-floor organization. Under such circumstances, subcontracting may be beneficial for the supplier, even if demand is unstable.

14. TNC customers tend to prefer stable, long-term relations with a limited number of reliable SME suppliers, as unstable supplier relations are usually not compatible with rising standards in quality and reliability. As a result, increasing barriers to entry exist for potential SME candidates. Such pressure improves working conditions and opportunities for technological upgrading within a select group of SME suppliers. Yet, even these linkages are not automatic and depend on specific policies and measures.

B. Linkages with technology partners

15. Corporate joint ventures, technology licensing and other forms of inter-firm alliances offer advantages to all the firms involved through information sharing, joint problem solving, cooperative resource sharing and collective implementation among them. From the perspective of SMEs in developing countries, these linkages are mainly seen as mechanisms to gain access to technological and managerial know-how, as well as to take advantage of the foreign partner's international reputation. Moreover, partnership may limit their financial exposure. The latter reason also holds true for the foreign partners, who are eager to share costs and financial risk especially in the first years of operation in a new, unfamiliar market, taking into account that such markets often involve high risks. Besides financial considerations, the main advantages of taking up a local partner are related to familiarity with the local way of doing business, including the political and institutional dimensions as well as knowledge of and access to markets.

16. Joint ventures and other technological alliances have proliferated, particularly in new technologies and the automobile industry. The reasons for undertaking such alliances include: the high costs and risks of R&D and technology development; the need to pre-empt other competitors by undertaking R&D rapidly; benefits from a mutual exchange of complementarities in R&D expertise; and a reduction of the time required to develop a product. Technology alliances by TNC systems can also involve the transfer of R&D related and other activities for one group of products to other firms, including in developing countries, so that the TNC system's operations at home can concentrate on products appropriate for high-income markets. Such alliances can also involve SMEs in home or host countries, where these firms gain access to capital equipment and other resources of TNC systems.[7] However, such partnering may be fragile and risky. The success highly depends on local partners' ability to bargain before entering an alliance and continuously renegotiate the conditions throughout the ongoing cooperation. At the same time, local SMEs should upgrade technologically and sustain substantive advantages which make them irreplaceable for the foreign partner, such as control of distribution channels, access to continuing sources of technology, control of export channels, etc.

17. In many cases, alliances between TNCs and developing country SMEs are fraught with difficulties due to the fact that partners often have different expectations and pursue separate and often conflicting goals. Local partners try to gain as much access as possible in terms of the specific knowledge and technology of their foreign counterparts. Yet, these assets are at the core of competitive advantages of any company, especially in the case of rapidly developing, knowledge-intensive industries. Therefore, the technologically more advanced partners try to avoid any leakage of specific knowledge relevant to their market position. On the other hand, the TNCs' need for access to local authorities, institutions, and markets are relatively easily

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[7] UNCTAD (1995:155-156).

met. In other words, the information access and the bargaining power are not shared evenly between the partners. Consequently, the benefits of the weaker one, usually the local SME, are likely to be limited.

C. Other spillover effects

18. TNCs sometimes transfer know-how to local SMEs not directly linked to them as suppliers, as a result of unintended spillovers.

19. *Demonstration effects*. TNCs often introduce new market channels, management techniques and ways of inter-firm division of labour. Local companies observe these innovations and copy or adapt them to their own needs. Demonstration effects help the local business community

- *to gain access to new export markets*: When TNCs open up new export markets and prepare the field for local followers, the latter may benefit from the reputation that the pioneering exporters have built up for local products and from established trade channels.

- *to introduce new management techniques*: TNCs often utilize advanced concepts of industrial organization. Since management techniques in many developing countries need substantial upgrading, the role of TNCs as showcases is especially relevant in this field. TNCs are much more willing to transfer knowledge about management techniques than production technologies. This is because management techniques are usually not specific to business activities and thus not considered core capabilities, while the leakage of specific production technologies may jeopardize the potential to gain innovation rents.

- *to increase inter-firm division of labor*: As more concentration on core capabilities and increasing specialization continues among firms, outsourcing of non-core capabilities and inter-firm alliances, such as research alliances, technology licensing and franchising, are rapidly gaining importance. Yet, specialization in stages of the value chain and cooperation with complementary firms are still much less frequent in developing countries than in industrialized countries. Foreign investors in developing countries can increase inter-firm division of labor.

20. Most of these transfers occur without active involvement of the TNC but rather through copying of ideas. However, more conscious and systematically organized processes aimed at exploiting demonstration effects, such as company visits and benchmarking programmes, have recently increased.

21. *Human capital spillovers*. TNCs usually have more advanced equipment and more up-to-date production processes as well as higher quality standards than local companies. As a result, they place higher demands on their workforce and invest more in employee training. New management techniques emphasize total quality, including propagation of work ethics, quality awareness and corporate identity, putting more importance on human capital investment. Most TNC affiliates in developing countries now offer regular training courses, ranging from basic courses on motivation or accident prevention to more specialized training in quality management, operation and maintenance of modern equipment, logistics, etc. Specialized workers are sometimes given training in the parent companies or other TNC affiliates abroad where they can apply new techniques, experience different business cultures and learn foreign languages. In other cases, TNC personnel are seconded to the local SMEs.

22. Even if employees do not participate in training activities, they may acquire certain skills, attitudes and ideas just by working in a plant that conforms to international production standards. Other employees

leave the TNC affiliate or the related SME and set up new SMEs. Some TNCs are thus "invisible colleges" which make substantial contributions to skill formation in the host country.[8]

23. *Effects on competitors*. TNCs entering a developing country's market may induce local companies to improve their production systems. In this sense, competition is an important driving force for local firms' technological learning. On the one hand, if the local competitors lag far behind TNC standards, FDI may drive these firms out of the market, attaining oligopolistic market power and hindering endogenous technological development. In such an environment, TNCs can quite often secure their market positions without making efforts to continuously improve their performance. On the other hand, if local companies are able to compete seriously with the TNC affiliates, the latter are forced to bring in new technologies to restore their advantages. Blomström, Kokko and Zejan show that there is a statistically relevant positive correlation between the technology imports of TNCs and the local competitor's investment and output growth[9]. The ability of potential local rivals to survive the competitive pressure of TNCs and respond with improved performance depends on several factors. Among them are the technological gap between TNCs and local firms, the entrepreneurial ethos of the latter, policy support available to them, size and structure of the local market, and the aggressiveness of TNCs.

Chapter II: UNDERLYING DETERMINANTS OF LINKAGES BETWEEN TNCs AND SMEs

24. The intensity of TNC-SME linkages and the ability of countries and individual firms to exploit them for technological upgrading vary greatly, depending on three sets of factors:

- the existence and efficiency of supporting public policies and measures that increases domestic SME investment and facilitates technology transfer and skills development;
- the TNC corporate strategy, which may be conducive to local SME development; and
- the existence of SMEs which are able to meet high TNC standards or at least have the potential to achieve such standards within a short learning period.

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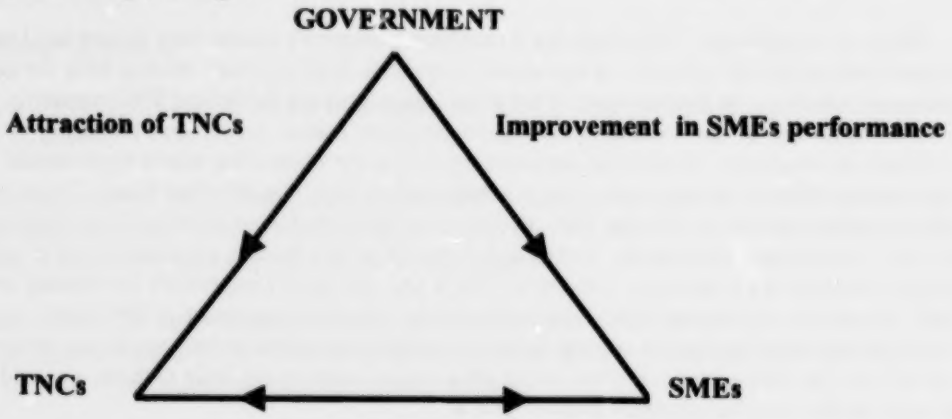
8 E.g. Best (1999:25) for the case of Malaysia.

9 Blomström,Kokko and Zejan (1994).

Box 1.1: The linkage triangle



TNC-SME linkages for technological and managerial upgrading

A. Role of policy and support measures

25. As the global economy becomes more open to international business transactions, countries increasingly have to compete for foreign investment. Many of them have relaxed restrictive FDI policies that could effectively deter TNCs from investing in host countries and have begun liberalizing their FDI framework. However, it is obvious that merely opening the door to FDI will not result in the country's economic development. Host countries usually formulate development strategies to promote growth, competitivity and diversity within their economies. The promotion of SMEs should be part of this general strategy. The question is, however, what is the central objective? Is it to promote growth and competivity or to advance social goals such as poverty alleviation?

26. Governments must determine in which sectors and niches their national comparative advantages lie and then attract TNCs which can assist in developing these sectors and niches based on their corporate global policies. It is advisable to move from general investment policies and promotion programmes towards specifically targeted ones. A study conducted by Wells and Wint shows that promotion was highly cost-effective when sector-specific investment promotion is combined with firm-specific research and customized advertising. In contrast, general advertising campaigns tend to yield fewer results.[10]

27. While many developing countries focus on a combination of low factor costs to attract FDI, such as labour and natural resources, as well as general infrastructure, these are basic and generalized factors which are usually not sufficient to sustain long-term competitiveness. In order to achieve technological upgrading, advanced and specialized factors of production must be developed which would encourage TNCs to transfer their technology to local firms. These include specific human-capital formation with a high percentage of engineering, science and business studies and logistics infrastructures. Developing countries are likely to

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[10] Wells and Wint (1990).

benefit from economies of specialization and agglomeration by building up an experienced pool of specialized labour as well as a network of cooperating firms in complementary fields.

28. Since competitiveness increasingly depends on the ability of firms to learn and master technological development, and since these are cumulative processes which generate significant externalities, there is much scope for market failure. Hence, a strong rationale for market interventions exists in the area of support measures. Yet, these interventions have to be carefully considered and moderated to minimize the risks of inefficiency and failure. Therefore, the relevant question is not whether or not to support and guide FDI and enterprise development, but rather to what extent intervention is required under the specific circumstances of a given country.

29. The optimum level of intervention depends mainly on the development level of the host country, the strength of its administration, the competitiveness of local suppliers, and the insulation of government from cronyism. Moving towards a more active and interventionist role of government requires a high degree of administrative efficiency and implies considerable risks.

30. In particular, interventionist policies to enhance linkages and spillovers between TNCs and local SMEs should always respect the principle of subsidiarity according to which responsibility is best exercised closest to a given situation. This implies that support measures should, wherever possible, be offered by private entities which operate at a decentralized level and are, thus, close to the customer. In other words, it must be clearly understood who can do what best among the various development players, including governments, meso institutions, and TNCs. The current general consensus in the international community favors minimal public sector interventions and largely restricting them to improving the general, legal and business framework for private-sector activities, to providing the basic logistics infrastructure and education, and to stimulating a market for business service providers.

B. TNCs corporate strategy

31. TNCs pursue different corporate strategies, which are usually closely related to their economic motives for operating in the host country. In the past, foreign investors operating in relatively closed domestic markets often developed substantial supplier linkages, not only because quality requirements were less rigid and economies of scale less relevant, but also because host countries often imposed domestic-content requirements. By comparison, investors seeking resources or focused on export-oriented industries created relatively few linkages, but these linkages with local suppliers were more competitive and sustainable. [11]

32. Beside the locational motives for investing in a given developing country, many other aspects shape the corporate strategy and the TNC's willingness to develop linkages with local SMEs. These include the degree of technological sophistication of the TNC and the economies of scale attained, the length of time operating in a host country, the geographic proximity and transaction costs between the TNC and its affiliates, the TNC's market position, such as whether operating in price-sensitive markets or enjoying high innovation rents, and the trade policies of the host country; i.e., whether inputs can be easily imported.

33. TNC's willingness to develop linkages is also influenced by its corporate culture, which, in turn, reflects cultural features of the TNCs' home country. For example, several studies have shown that United States and European electronics and computer companies have used their Southeast Asian affiliates for

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[11] Reuber et al. (1973):152 ff.); Dunning (1992: 450 ff.).

specialized production in a global division of labor, therefore beginning a process of systematically upgrading the technology, improving quality control and expanding managerial responsibilities of their subsidiaries. Japanese TNCs, on the other hand, have maintained higher value-added operations in Japan, while transferring only lower-end processes to their foreign affiliates. In the automobile industry, managers of United States companies are free to expand exports even at the expense of their own parent company, while Japanese parent companies explicitly restrict exports of their foreign subsidiaries.

34. Extensive outsourcing usually requires building up long-term partnerships and investing in comprehensive supplier development schemes. Depending on their strategy, TNCs may form foreign enclaves with almost no local spillovers (e.g. many apparel companies in Free Production Zones), but they may also create new productive capabilities and opportunities, increased technological diversity and induce technological learning in its business environment. The development impacts are more common in industrialized countries where more innovative SMEs exist to fill in the many "interstices" created by dynamic TNCs. Yet, some of these aspects may be observed in developing countries as well.

Box 1.2: Key features of TNC strategies that coincide with deepening linkages*

- **Investment driven by the search for strategic capabilities and assets rather than for cheap natural resources, low wages or protected local markets**
- **Expansion of the pool of technical and organizational knowledge available in their host country through in-house education and training of workers and managers**
- **Participation in public-private partnerships to improve the skill base of their host region**
- **Stimulation of continuous innovation inside the company and in its environment**
- **Incorporation of local personnel in management and the adoption of products and processes to local markets, norms and values**
- **Generation of new business opportunities in related fields beyond reach**
- **Business models based on networking and inter-firm cooperation**
- **Comprehensive outsourcing strategies**
- **Act of system integrator initiating and coordinating production networks**
- **Cooperation with other enterprises based on a vision of synergetic long-term partnerships rather than short-term interests**
- **Decentralized corporate decision-making and empowered local management to authorize independent sourcing and new product development**
- **Provision of affiliates with R&D facilities**
- **Fast growth based on productivity dynamics rather than use of additional factors of production Commitment to the local business community and willingness to share their experiences without jeopardizing the company's core competencies**

*Partly based on Best (1999)

35. Government can enlist the support of certain TNCs in building linkages because many profit-seeking TNCs are concerned with the issues of corporate responsibility since they live in a media-driven world. They understand that they need an implicit license to operate in their societies. All societal groups are expected to perform certain roles and functions that can change overtime. Expectations related to TNCs are undergoing unusually rapid change due to the expanded role of these enterprises in the global economy. The social contract stipulates that with power and rights go certain responsibilities. Some TNCs interpret the concept of corporate social responsibility (CSR) in a broad sense; that is, they have an understanding and

acceptance of obligations, which go beyond those of shareholders and include obligations to other stakeholders. A number of TNCs act on the basis of their own company-wide policies and well-defined principles rather than on ones which are externally imposed. For example, UNILEVER's corporate philosophy is based on its desire to be an integral part of society as a contributor. TNCs, which have a broad interpretation of CSR, consider their impacts on other groups outside of shareholders such as employees, managers, suppliers, customers, and even competitors, local communities and governments. Stakeholder theorists point out that many parties affected by institutional corporate activity may have neither the economic ability to signal their needs through market mechanisms nor the political power to ensure their representation through government regulation. These situations can, therefore, invoke the subsidiarity principle where both a firm's capability and its impact on those around it become critical factors in determining the nature and the degree of a corporation's responsibilities.[12]

C. The competitiveness of local SMEs

36. When TNCs were asked what their most important criteria were for partnering with an SME, they first mentioned attitude; the SME must have the will to succeed and the will to transform.[13] Furthermore, the SME must have its own strategy or vision for the future as well as good financial management.

37. In global production chains, different types of supplier relations do not contribute equally to the development of a competitive SME sector. Depending on the innovative capabilities of the SME suppliers and the motives of the TNC customers, three main types of supplier relations may be distinguished. Barriers to entry are lowest in the first and highest in the last.

Low-cost suppliers with limited organizational capabilities. The suppliers do not possess specific knowledge-based factors and are usually less efficient than their customers or other potential suppliers in terms of production processes and product quality. Yet, lower labor costs or their willingness to accept unstable demand conditions may outweigh these deficiencies, especially in technologically simple and labor-intensive activities. Although most TNCs prefer to work with more or less formalized suppliers that meet basic labour standards, those suppliers may in turn employ second-tier sub contractors in the informal sector.

Low-cost suppliers mastering modern organizational principles. Compliance with quality standards is becoming more and more important, especially where production is associated with a company or brand name. Even if supplier relations are cost-driven, most TNCs will not compromise on quality. Failure of a single supplier may threaten the customer's competitiveness and reputation. Therefore, more and more TNCs expect their suppliers to accept rigid guidelines concerning quality, cost and delivery (see Box 1.3).

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[12] In the wake of the Asian financial crisis, a number of local suppliers of Toyota in Thailand faced severe liquidity problems. Toyota realized that without a stable network of local suppliers, its own existence was at risk, and thus initiated various support measures in order to keep its supply chain afloat. The actions undertaken by Toyota Thailand included price adjustments to mitigate adverse effects of the exchange rate fluctuations, advanced purchases to increase turnover, compensation of excess inventory stemming from declines in orders, job transfers from local companies to local joint ventures to utilize excess capacity, and an increase in the volume of local inputs at the expense of imports. Muramatsu (2000).

[13] During the "UNCTAD International Meeting on Technological and Managerial Upgrading of SMEs through Linkages with TNCs" held in Penang, Malaysia on 8-9 August 2000, TNCs were asked their views on what they regarded as the most important characteristic in potential SME partners.

In many cases, suppliers are obliged to implement quality management strategies and to become certified by Good Manufacturing Practice (GMP) or ISO standards. Outsourcing of this kind is still motivated by considerations of production costs, for example, in order to avoid investments in costly specialized equipment for certain inputs (e.g. auto parts, machine tools). The supplier does not necessarily possess exclusive know-how and may still be replaced by in-house production. Yet, the more the supplier specializes in certain operations, and the more experience it gains, the more likely the relationship evolves from one-way subcontracting to a two-way partnership. Barriers to entry in the form of technical expertise, capital costs, or costs of certification may be relatively high for this type of supplier.

Box 1.3: Xerox- Requirement for SMEs to be accepted as suppliers

SMEs willing to supply parts to Xerox affiliate must

- accept Xerox guidelines concerning quality, cost and delivery;
- implement *just-in-time*-delivery;
- accept that inventory belongs to the supplier;
- accept *pay after use*;
- take 100% responsibility for parts and accept penalties for non-performance;
- develop a methodology of *continuous improvement*;
- accept a company survey conducted by Xerox personnel, analyzing (among other things) the internal organization, conditions and layout of plant, quality management, products, equipment, technical resources, input materials, sourcing strategy, production costs, secondary activities, clients, evaluation of performance by clients and trade union activities;
- promise to solve problems detected;
- established electronic communiation with the client;
- develop joint strategies and action with Xerox;
- apply the same principles to second-level suppliers.

Souce: Extract from a Xerox document prepared for Mexican suppliers (Xerox 1997)

Innovative specialist suppliers. Suppliers in this category, especially those in technologically complex activities such as electronics and automobiles, are required to invest in R&D on their own in order to constantly improve their products and participate in joint innovation projects with their TNC customers. They build up specific expertise that the TNC cannot easily replace with in-house resources. Barriers to entry in this segment of innovative suppliers are high. As very few SMEs in developing countries are capable of developing innovative technologies, the increasing degree of specialization between TNCs and SME suppliers sometimes leads to the formation of transnationalized enterprise clusters, with leading suppliers from OECD countries following their principal TNC clients to production sites in developing countries.[14]

[14] See Altenburg and Meyer-Stamer (1999: 1703 ff.) for this tendency to form clusters of transnational corporations.

38. In summary, the linkages based *exclusively* on low wages and labor standards do not foster technological learning and productivity growth, and thus rarely create a basis for sustained competitiveness. If firms want to embark on a "high-road" strategy of technological upgrading that allows them to move into activities with higher returns, local SMEs must be able to meet the following criteria:

- to have the desire to succeed and commitment for continuous learning;
- to achieve minimum efficiency standards and continuously improve these standards;
- to analyze their own strengths and weaknesses, and set forth strategies to enhance their comparative advantages;
- to identify suitable TNC partners, with which a sustainable linkage may be anticipated;
- to carefully negotiate contracts which are favorable in the long run, taking into account the fact that framework conditions and partner relations usually change over time;
- to be able and willing to transform themselves according to the needs arising in the partnership; and
- to contribute specific assets to the TNC partners, e.g., not only familiarity with local politics and government regulations as well as knowledge of local markets, which may erode as TNCs learn to handle the local way of doing business, but also new advantages.

Many SMEs, particularly in LDCs, are not able to meet these criteria. Hence special support measures are required and are outlined in the following chapter.

Chapter III: BEST PRACTICES

39. A number of innovative approaches to creating linkages have been undertaken by TNCs such as Hitachi, Intel, Motorola, Philips, and Toyota to name a few. Many useful lessons were learned about successful linkages and partnerships during a three-day workshop jointly organized by Intel and UNCTAD in Malaysia on "technological and managerial upgrading of SMEs through linkages with TNCs."[15] 26 case studies from 7 Asian countries illustrated various practices used by TNCs to upgrade SMEs. Those innovative approaches which are analyzed in this chapter did not spring up spontaneously. It is important to highlight the role of the Penang Development Corporation (PDC) in promoting linkages. The basic principal and winning formula of PDC was to initiate "smart partnerships" in manufacturing among TNCs, SMEs, and government.

40. TNCs increasingly tend to perceive the building up of complex SME supplier networks as a long-term investment. They are influenced both by cost considerations and by reliability considerations. SMEs can play a very important role in ensuring that TNCs remain globally competitive. The ability and capacity of SMEs to provide world-class services and products in the supply chain reduces the cost and dependency of TNCs on imported materials. As corporations strive to reduce cost and cycle time in the ever competitive global economy, TNCs are compelled to assist the development of their local suppliers to grow in tandem with their business. Thus, they are willing to provide substantive amounts of human and financial resources

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15 The workshop took place in Penang, Malaysia on 8-10 August 2000.

to strengthen the competitiveness of the SME partners. The case studies presented at the workshop suggest that best practices include:

- the facilitation of SMEs' access to TNC innovation centres,
- the assignment of TNC staff including engineers and management consultants to SMEs and
- the phased upgrading of productive capacities starting with operations and plant layout and moving on to design capability, flexible manufacturing, ISO certifications and R&D capabilities.

41. Most importantly, TNCs entered into a partnership with the government to upgrade skill levels. A case in point is the Penang Skills Development Centre (PSDC) which is the result of a strategic alliance between the State Government of Penang, industry (i.e., TNCs and local firms), and academia. PSDC is a one-stop human resource development centre established in 1989 to address the shortage of sufficiently skilled manpower. The State Government provides the political will and physical infrastructure. Industry members provide the leadership, course guidance and equipment. Academia provides training materials and teacher training. Although initiated by the State Government through the PDC and aided by academia, management expertise and administration are left to the industry.

42. All enterprises that are members of PSDC send a qualified representative to the PSDC training committee. Among its many tasks, this committee prepares a yearly training calendar of courses to be conducted, monitors, evaluates and obtains feedback on their effectiveness. As a result, PSDC's training reflects the needs of the industry and its courses are able to figure prominently in member companies annual training plans

43. PSDC industry members pool their resources together to help plan, design and conduct an extensive range of training programmes directly relevant to immediate and forecasted needs. This enables the PSDC to offer the most cost-effective training for industry and at the same time bridge the gap between skills taught in public institutions and skills required on the job. *Such tailored skills development training is an important factor in an SMEs' ability to absorb technology and engage in continuous innovation.* A recent UNCTAD study shows a very weak relationship between basic education (up to the tertiary level) and the technology intensity of exports. The conclusion was that TNC involvement contributes more to competitive skills than basic education especially where the TNCs do both on –the- job training and collaborative classroom training as happens at PSDC.[16] State-of-the-art equipment, computer hardware and software donated by industry and the government enables PSDC trainees to learn using the same industry-standard tools found in modern factories. Since 1989 PSDC has already trained 60,000 workers from TNCs and SMEs. Main programmes include short-term programmes in a variety of technical subjects, apprenticeship programmes in engineering as well as a three-year technical engineering degree for school leavers, a bachelors degree in engineering, a masters degree in engineering business management or microelectronics, and a professional IT qualification programme.

44. One of PSDC's most innovative programmes, which directly build linkages between TNCs and SMEs, is the global supplier programme (GSP). [17] Its objective is to develop and upgrade capacities of local companies through training and linkages with TNCs. Again, the programme is a joint effort between the State Government and industry. The State Government provides certain financial incentives, industry shares resources and expertise, and the SMEs make a commitment to undertake transformation. The programme

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16 UNCTAD (forthcoming).
17 PSDC (2000a).

consists of two initiatives: basic training in critical skills and linkages with TNCs. In the first part manufacturing and material suppliers are trained in critical skills and competencies to adopt and use new technologies. In the second part of the programme, TNCs adopt local companies and "hand-hold" them for upgrading in leadership skills and technology. This initiative calls for investment of time and commitment by both the large corporations and SMEs. The success of this mentoring or coaching becomes apparent when suppliers have attained the level of competency to become global players themselves. An important part of the linkage programme is the periodic assessment and review of the SME by the TNC and benchmarking to remain on track.

45. SMEs in the workshop also mentioned that the sharing of knowledge with TNCs about market trends was crucial for keeping up with their partners. Also TNCs had helped SMEs develop other business opportunities outside of the linkage programme. The State Government, in particular, encouraged TNCs to engage in business match-making and to broker strategic alliances. SMEs said that it was important for TNCs to allow the SMEs to support TNC operations elsewhere outside the host country in order to go global.

46. This blueprint for growing competitive SMEs seems to have had an impact on job creation, income generation, exports and enterprise internationalization over the past ten years. The State Government has provided the basic educational and logistic infrastructure. Government, TNCs, SMEs and academia have entered an alliance to bridge the gap between formal education and the skills needed by the market place by creating the PSDC. The Centre has developed specific programmes for getting SMEs partnership ready and TNCs have nurtured and mentored SMEs in this programme. In the end the host country has harvested additional benefits when the SMEs have gone global.

47. In general, the best practices showcased by the case studies are guided by the principle of subsidiarity. Lessons learned are that the conditions for success include:

- Governments must act as catalysts by providing and continuously improving logistics and educational infrastructure, particularly for the development of engineering and management skills. The enabling business environment must be founded on a meaningful and continuous public-private sector dialogue, so that the public sector understands the business needs of TNCs and SMEs alike. Investment policies and promotion measures must target those TNCs which are committed to development and willing to enter supplier development programmes.

- The public and private sectors, as well as academia, must work together to create "meso" institutions, such as skill training centers, to facilitate transfer of technology and to achieve the capacity for continuous innovation.

- TNCs act as agents of change or anchor companies working with SMEs for technological and managerial upgrading by adopting SMEs and coaching them in continuous improvement. They must provide business opportunities with other international partners. TNCs, with their vast potential, can facilitate universal access to information technology and the capacity to embrace new methods of commercial transactions, including e-commerce.

- SMEs must have the commitment to compete, to survive and to succeed. Moreover, they must have a vision of their own evolution and be prepared to change their mind set in line with new opportunities and requirements. They must focus on core competencies, while at the same time must be flexible, willing to learn and be committed to continuous improvement.

- The creation of linkages between TNCs and SMEs must be based on trust, confidence and long-term vision. It requires open communication, a regular flow of critical information and sharing of knowledge concerning all aspects of development that are essential for productive partnerships.

Chapter IV: POSSIBLE ISSUES FOR DISCUSSION BY EXPERTS

48. Policies and measures for attracting FDI and for enterprise development are interrelated, and cannot be considered in vacuum. Hence governments' policy vision and strategy on enterprise development will influence FDI attraction and vice versa. In providing an enabling business environment and in its dialogue with the private sector, the government must have a clear vision of why, how and which part of the enterprise sector needs to be promoted. Some national and donor-driven SME programmes providing indiscriminate assistance to SMEs in traditional activities where they do not possess competitive advantages vis-à-vis large firms might be of little help when it comes to coping with the ongoing structural change.[18] The challenge is to establish a core group of dynamic SMEs. This calls for selective policies and programme measures. To be effective, such programmes and measures should be part of a holistic and coherent policy framework, which takes into account the different and complementary roles of government, the private sector and the international community. The expert meeting may wish to reflect on the following sets of issues that will require the commitment and partnership of all development actors.

A. The role of the government[19]

49. The occurrence of TNC linkages and spillovers relies on the creation and further development of an enabling business environment. Such an environment is characterized by:

- the existence of a sound legal, regulatory and tax framework;
- the continuing availability of a skilled labour pool through education and training programmes;
- a well developed infrastructure, especially transportation and telecommunication;
- a continuing public-private sector dialogue on programmes for effective enterprise development; and
- the encouragement of TNCs to create supplier links via targeted investment policies.

50. In this context governments could also adopt a comprehensive set of selective support measures to promote linkages. Criteria for selection include the competitiveness of sectors in which potential partner firms operate, the dynamism of particular SMEs in that specific sector and their capacity to specialize in activities which complement that of potential TNC partners. Such proactive partner selection does not have to be limited to local SMEs. Equally stringent, though differing, selection criteria could be used for the identification of TNC partners: that is, which TNCs, in the view of the government, are likely to have a positive impact on development; in other words, does the firm either pursue development strategies, or could it foreseeably contribute to the development goals and targets set by the government.

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[18] For example, it should be noted that fast-growing SMEs in innovative areas rarely grow out of the existing stratum of micro- and small firms, since they usually face various internal barriers to growth, including lack of managerial capabilities, technical expertise, skilled workforce, capital, and growth orientation.

[19] As noted in the beginning of this paper, it was not the intention to once again focus on government policy. However, at this point, it is useful to start the conclusion on practical measures with a brief summary of the policies, which are pre-conditions for taking action to promote linkages at a number of levels.

51. Once governments have gone through the stage of identifying those strategic enterprise sectors and investors, support measures have to be put in place in order to make the local enterprises partnership-ready. Questions to be asked at this stage include:

- Once a business enabling environment has been created, what other specific policies could it adopt which would promote TNC-SME linkages?
- How does the principle of subsidiarity influence the extent of government intervention?
- What role does public-private sector dialogue play in formulating policies and support programmes?
- What is the scope for meso institutions?
- Should government intervention be restricted just to remedy market failures in the areas of information, labour, capital, and technology?
- To what extent do present and future trade and investment commitments limit the scope for special support measures?
- Under what criteria would economic incentives be appropriate for building linkages?

B. The role of the private sector

1. Business Associations

52. Business associations have an important role to play in facilitating and enhancing the formulation of SME-TNC linkages. The effectiveness of their role is directly related to the level of public-private sector dialogue established. Important measures taken by the business associations, not only to support and complement governmental policies and measures but also to tailor them more appropriately to the needs of the enterprise community, should include:

- advice to the governments on the formulation of appropriate policies and strategies;
- development of networks among suppliers, clients, business development support agencies, financial institutions, government offices, and NGOs;
- assistance in pre-selection of potential local firms as suppliers to TNCs by preparing updated catalogs of enterprise profiles, supplying a maximum of clear and relevant information on the existing and potential capabilities of enterprises interested in partnering ventures;
- fostering partnership between TNCs and local SMEs through improved contact between them, by organizing fairs, exhibitions, and other trading events, facilitating participation in such events, or disseminating information on the advantages of creating links as well as on existing support mechanisms and governmental programmes; and
- partner preparation by providing institutional assistance required for SMEs' capacity upgrading, vertical and horizontal matchmaking.

53. Business associations can also contribute to the SME-TNC partnership development through mitigating negative impacts of such development on the society. For example, local firms may be informed of the risk of unwanted westernization, or loss of traditional crafts and skills. Moreover, unsustainable competition among local firms could be avoided through close collaboration with the associations. For example, measures could be introduced to discourage damaging cost cutting practices or supplier pyramids, where local firms are at the bottom.

2. TNCs

54. The existence of competitive SME suppliers is beneficial for TNCs. In order to foster the network of competitive local suppliers which are capable of maintaining long-term partnerships with TNCs, they could establish corporate strategies to facilitate SMEs' access to TNC innovation centres and engineers;train SMEs employees through rotational assignments of qualified technical and management staff from TNCs to SMEs and vice versa;

- gradually upgrade the productive capacities of SMEs from operations to technological capabilities;
- participate in adoption, mentoring, coaching programmes;
- share knowledge with local partners regarding market trends;
- support local partners financially or facilitate their obtaining bank loans; and
- help local partners develop other business opportunities abroad.

55. Once the government has created an enabling business environment, the private sector should consider:

- What other forms of support do they need to partner with local firms?
- Is there a preferred form for partnership? Subcontracting, joint ventures, strategic alliances?
- What qualities do they look for in a partner?
- What are the requirements for entering their supply chain?
- Does the company have a stated company-wide policy on local partnering?
- What is the most likely motivation for forming local partnership? Company policy? Economic sector or activity? Local conditions or requirements?
- What benefits do TNCs realize from local partnerships?
- What type of specific programmes do they have in place to create such linkages?

C. The role of the international community

56. As a major source of employment and, thus, income, local SMEs in developing countries are considered to be engines of economic growth. Particularly, in the globalization process where many societies in the developing world are in the process of adjusting to its impact, local firms are seen as the source of dynamic economic and social change. The international community can work towards achieving an equitable economic, social and political balance by:

- initiating and developing dialogue on elements for an international environment conducive to the creation of sustainable, equitable TNC-SME linkages which are likely to have positive impacts;
- creating international models for TNC-SME linkages, through exchanges of experiences and dissemination of best practices with the participation of relevant stakeholders in the process; e.g., TNCs, SMEs, governmental agencies and institutions, and civil society;
- complementing national, regional and sub-regional efforts for investment promotion in general;
- eliminating barriers to SME growth and export expansion, such as export barriers, discriminatory rules of competition, quality, health and sanitary standards; and
- increasing support for technical cooperation in entrepreneurship development and institutional capacity building.

57. Other questions can be raised in the context of the global environment on foreign direct investment:

- Should the global compact of the Secretary-General be expanded to include the impacts of TNCs on development?
- How do regional integration agreements affect the likelihood of creating linkages with local firms versus firms in the region?
- What role can international organizations play in strengthening local institutional capacities to provide support programmes for SMEs?

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